

Research Update:

Bank of North Dakota Ratings Raised On Bank Criteria Update; Outlook Stable

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Overview

- Following a review of Bank of North Dakota (BND) under Standard & Poor's revised bank criteria (published on Nov. 9, 2011), we have raised our long-term issuer credit rating on BND to 'AA-' from 'A+' and the short-term issuer credit rating to 'A-1+' from 'A-1'. The outlook is stable. At the same time, we have affirmed our 'AA+' rating on the bank's deposits, which parallels our issuer credit rating on the state of North Dakota.
- The anchor for BND is 'bbb+'. Our ratings reflect BND's strong business and risk positions, strong capital and earnings, average funding, and adequate liquidity. The 'AA-' issuer credit rating on BND also incorporates a one-notch uplift from its 'a+' SACP, based on the application of our criteria for GRES.
- We expect that BND's strong capital and earnings and excellent asset quality will remain positive rating factors, despite the bank's limited geographic diversification.

Rating Action

As we previously announced, on Dec. 6, 2011, Standard & Poor's Ratings Services raised its long-term issuer credit rating on Bank of North Dakota (BND) to 'AA-' from 'A+' and the short-term issuer credit rating to 'A-1+' from 'A-1'. The outlook is stable. At the same time, Standard & Poor's affirmed its 'AA+' rating on the bank's deposits.

Rationale

Standard & Poor's bases its ratings on BND on the state of North Dakota's (AA+/Positive/--) ownership of the bank, and the bank's "strong" (as our criteria define it) business and risk positions, "strong" capital and earnings, "average" funding, and "adequate" liquidity. The bank's geographic concentration in North Dakota, its indirect exposure to the agriculture industry, and its limited capital flexibility constrain the ratings. The rating includes a one-notch lift from the company's 'a+' stand-alone credit profile (SACP), based on the application of our criteria for government-related entities (GRES). As an entity that the state owns, controls, and maintains, we believe that there is a high likelihood that the state of North Dakota would provide timely and sufficient extraordinary support to BND, if necessary. Moreover, the state explicitly guarantees all of BND's deposits, as codified in the North Dakota Century Code (NDCC §6-09-10). The 'AA+' rating on the bank's deposits parallels our issuer credit rating on

the state of North Dakota. None of BND's other liabilities have an explicit guarantee.

Our bank criteria use our Banking Industry Country Risk Assessment (BICRA) economic and industry risk scores to determine a bank's anchor, the starting point in assigning an issuer credit rating. Our anchor for a bank operating only in the U.S. is 'bbb+'. Our economic risk of '3' for the U.S. reflects our view that the U.S. has a highly competitive, resilient, and diverse economy. However, the economic recovery remains weak, and private-sector leverage is still high despite four years of deleveraging. Our industry risk score of '4' reflects the U.S. financial system's considerable regulatory challenges and the competition from a large and active shadow banking segment. However, we view funding risk favorably because U.S. banks typically benefit from a high and stable share of core deposits and exceptionally deep capital markets.

We view BND's business position as unique but "strong." The bank, which is headquartered in Bismarck, ND, was created because of a dearth of lenders in the state willing to support local businessmen and farmers. BND had total assets of \$4.7 billion as of June 30, 2011. The bank's deposits are not federally insured, and it gets no oversight from U.S. government authorities or banking regulatory bodies. Still, the state is required by law to guarantee all of BND's deposits. Because of that guarantee, we rate the deposits 'AA+', the same level as the state. The banks' static deposit base supports its primary role in financing economic development in North Dakota. The bank has only one office and acts as the agent of several state-legislated programs, a lender, a depository for state agency funds, and a correspondent bank to private financial institutions in the state. We view BND's management strategy as conservative and supportive of the bank's business goals. We expect management to continue meeting the needs of its customers as it fulfills its mission to deliver quality and sound financial services that promote agriculture, commerce, and industry in North Dakota.

We assess BND's capital and earnings as "strong," which reflects the company's strong quality and quantity of capital, and its strong earnings. Despite BND's limited capital flexibility, the bank's risk-adjusted capital (RAC) levels ranks high among its rated peers, reflecting its moderate risk asset mix and good earnings performance. The bank typically makes a large appropriation to the state's general fund, which limits capital. Because of the continued strength of the state's financial performance, BND will not have to make any appropriation payout for 2012 or 2013. The bank did not make payments during 2010 or 2011. We expect that our RAC ratio for BND will remain in the "strong" category, which ranges from 10%-15%, over the next two years. The bank's regulatory capital ratios easily exceed the minimum requirements for a well-capitalized bank. The quality of capital is strong, consisting mainly of retained earnings and common equity.

BND's earnings are strong, in our view. The bank's profits continue to increase because of a strong and growing low-cost deposit base and North Dakota's strong economy relative to other states'. The bank is tax-exempt, and it does not pay any deposit insurance premiums or require the deposit-taking

overhead of a large branch network. The bank has a captive deposit base that is not dependent--as most commercial banks are--on expensive "brick and mortar" branches and the related overhead costs. BND's overhead was a peer-leading 20% as of June 30, 2011. Because of the nature of its business and its static customer base, BND's net interest income makes up the majority of its revenues, with noninterest income accounting for only 6% of revenues. Because of the low-risk nature of the bank's balance sheet, we expect that the hiatus from appropriations payment will boost its profitability and, accordingly, its capital levels, for at least another two years.

We assess BND's risk position as "strong." The bank supports its business goals and works with state agencies and private banks in the state as a resource to promote its charter objectives. Despite its risk concentration in one state, BND maintains strong asset quality. Nonperforming loans, including those 90 days past due, amounted to 2.04% as of June 30, 2011, and net charge-offs, which have been managed exceptionally well, had a very low ratio of 0.05%. A large percentage of BND's deposits come from the state, representing a weakness, but this concentration risk is mitigated because state law requires these deposits to be made with BND. Furthermore, because of the extensive reach of agriculture in the state's economy, all loans, regardless of type, are indirectly related to the agricultural sector. Nonetheless, the state's economy continues to post strong revenue performance and boasts the lowest unemployment rate in the U.S., so we don't see this as a high risk at this time.

The bank's funding is "average" and its liquidity is "adequate," in our opinion. Funding is different for BND from that of other commercial banks. By state law, all state funds and funds of state institutions are deposited with BND. None of those deposits are federally insured, but they are guaranteed by the state. Noncore deposits provide the majority of BND's funding, while core deposits constitute roughly 26% of its funding base. Because core deposits do not fully fund the loan portfolio, the loan-to-deposit ratio is high at 259%. Noncore deposits primarily consist of large certificates of deposit from local state agencies, which the law requires them to deposit at BND. When those state-sourced captive deposits are added to the core deposits, the loan-to-deposit ratio improves to 74%. We recognize the stickiness of these deposits. The bank also has access to additional funding from the Federal Home Loan Bank of Des Moines, and it can borrow from the Federal Reserve discount window. The bank can also enter into a repurchase agreement using the securities in its \$584 million available-for-sale investment portfolio as collateral.

Outlook

The stable outlook reflects our expectation that BND will continue to perform well, with excellent asset quality and strong capital. We could lower the ratings if the state's economy weakens, or if the bank's asset quality weakens materially. For example, all else remaining equal, we could lower the ratings if the NPAs were to increase above 4%, or if losses were to cause capital

levels to decline and the RAC ratio falls and remains consistently below 10%. We could raise the ratings on the bank's deposits if we raised the issuer credit rating on the state of North Dakota.

Ratings Score Snapshot

Issuer Credit Rating	AA-/Stable/A-1+
Bank Holding Company Rating	--
SACP	a+
Anchor	bbb+
Business Position	Strong (+1)
Capital and Earnings	Strong (+1)
Risk Position	Strong (+1)
Funding and Liquidity	Average and Adequate (0)
Support	+1
GRE Support	+1
Group Support	0
Sovereign Support	0
Additional Factors	0

Related Criteria And Research

- Banking Industry Country Risk Assessment Methodology And Assumptions, Nov. 9, 2011
- Banks: Rating Methodology And Assumption, Nov. 9, 2011
- Group Rating Methodology And Assumptions, Nov. 9, 2011
- Bank Hybrid Capital Methodology And Assumptions, Nov. 1, 2011
- Rating Government-Related Entities: Methodology And Assumptions, Dec. 9, 2010

Ratings List

Ratings Raised

	To	From
Bank of North Dakota Counterparty Credit Rating	AA-/Stable/A-1+	A+/Stable/A-1

Ratings Affirmed

Bank of North Dakota Certificate Of Deposit Local Currency	AA+/A-1+
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the Global Credit Portal at www.globalcreditportal.com. All ratings affected by this rating action can be found on Standard & Poor's public Web site at www.standardandpoors.com. Use the Ratings search box located in the left column.

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